TRENDS IN MUNICIPAL LEASING

Report

Prepared at the Request of
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

May 1983

Congressional Budget Office
Congress of the United States

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J932-28

INTRODUCTION AND BACKGROUND

In the past few years, leasing has become an increasingly important municipal financing tool. Municipal leases take many forms and frequently substitute for tax-exempt bonds. The most common alternatives to long-term general obligation bonds are tax-exempt leases and sale-leasebacks.

Tax-exempt leases provide for the municipal purchase of property or equipment under an installment sales contract calling for periodic payments of principal and interest. The interest payments are exempt from federal taxation. Local governments use tax-exempt leases to buy all kinds of equipment, from typewriters to school buses, and, to a lesser extent, real property.

Sale-leaseback agreements make it possible for local governments and other nontaxable entities to benefit from tax deductions normally available only to the private sector. Under these agreements, a local government or a tax-exempt institution sells real property to private investors and simultaneously leases it back. The private entity puts equity into the property and in return gets rental payments and the tax benefits of ownership, which include interest deductions, depreciation deductions and, occasionally, investment tax credits. These tax benefits are generous and can be passed on to the lessee in the form of lower rental payments. Sale-leasebacks work for all manner of facilities, from college campuses to city halls, and their use is growing.

In general, the trend in municipal financing has been away from traditional general obligation bonds and toward mechanisms that make it possible to avoid seeking voter approval and to raise funds without being subject to established debt limits. The growth in the use of revenue bonds and, more recently, innovations in municipal leasing are manifestations of the search for new funding sources. So far, the growth in municipal leasing has been difficult to document with any precision. Although anecdotal information on individual projects is easy to come by, hard data on leasing activity nationwide are unavailable. As a result, it is impossible to measure the effect of municipal leasing on federal revenues. Although leasing is often a substitute for tax-exempt bond financing, it may sometimes lead to borrowing that would not otherwise occur and therefore to higher revenue losses. Since the availability of alternative financing is conjectural, increased revenue losses are very difficult to estimate.

From the standpoint of tax policy, the growing use of sale-leasebacks is a significant development. Local governments now have a much stronger incentive to sell public property to private parties than in the past. The incentives are much stronger because of the more liberal depreciation allowances and investment tax credits permitted under the Economic Recovery Tax Act of 1981 (ERTA).

The attractiveness of sale-leaseback arrangements appears to be an unintended effect of ERTA, which, in time, could have negative effects both on resource

allocation and on federal revenues. At present, private entities are buying public buildings primarily to benefit from tax deductions: without the incentives in current tax law, these investments would be unlikely to occur. The costs involved in many sale-leasebacks include the federal revenues foregone from issuing tax-exempt industrial revenue bonds (IRBs) to finance property acquisition and rehabilitation, and the value of depreciation deductions and investment tax credits. In most cases, sale-leasebacks are less costly to municipalities than issuing general obligation bonds. For the federal government, however, municipal sale-leasebacks at times may be more costly, since the revenue loss from accelerated depreciation and investment tax credits may exceed that from tax-exempt bonds. Institutions without the authority to issue tax-exempt debt may also conclude sale-leaseback arrangements. In these instances, the revenue loss to the federal government is even greater, since the sale-leaseback may be taking the place of taxable rather than tax-exempt financing.

Use of Leasing by Tax-Exempt Entities

Tax incentives, such as accelerated depreciation and investment tax credits, were designed to benefit only taxable entities. Sale-leasebacks provide a way for nontaxable entities to benefit from tax incentives. The safe-harbor leasing provision, enacted in 1981 and repealed the next year, also would have extended tax incentives to nontaxable firms by allowing them, in effect, to sell tax breaks they were unable to use to firms with enough tax liability to use them. Safe-harbor leasing was intended to provide equal investment incentives to firms with different tax liabilities but similar investment opportunities. The rationale for it was that firms with sufficient tax liabilities to offset all of their credits and deductions had a comparative advantage over others because they could afford to make less productive investments than firms with little or no tax liability would be likely to make. In theory, safe-harbor leasing established a level playing field for both kinds of firms, allowing the productive value of the investment itself to determine whether it would be made. In practice, safe-harbor leasing seemed to improve the neutrality of investment incentives when used by firms that expected to be nontaxable for temporary periods and to have the opposite effect when used by firms that expected to be nontaxable for long periods.[1] An assumption underlying safe-harbor leasing was that sooner or later income from profitable investments would offset tax deductions so that tax revenues would flow back to the federal government. In the case of municipalities and tax-exempt institutions, however, the benefits that indirectly flow to them from leasing are never offset by profits and never have to be paid back. When nontaxable entities can benefit indirectly from depreciation deductions and investment tax credits, they have an advantage over taxable entities in the

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1. Analysis of Safe-Harbor Leasing, a report prepared by the Staff of the Joint Committee on Taxation for the Committee on Ways and means, U.S. House of Representatives, and the Committee on Finance, U.S. Senate, p. 34.

competition for investment resources. In permitting safe-harbor leasing of mass transit commuting vehicles for governments and public transportation authorities, the Congress clearly intended to give certain nontaxable entities such an advantage.[2] But whether the Congress intends that advantage to exist in other situations is an open issue.

The prevalent practices in municipal leasing are described in more detail below.

TYPES OF LEASING AND THEIR USES

Operating Leases

Operating (or true) leases are arrangements in which the lessee acquires use, but not ownership, of property for a term that is shorter than the asset's useful life. Lease terms are often only a year, and the property belongs to the lessor both during and upon expiration of the lease. Under current law, a nonexempt lessor must pay income taxes on the lease or rental payments. If the lessee is a governmental unit, the lessor may claim some, but not all of the benefits of ownership. Specifically, depreciation deductions are permitted, but the investment tax credit is not available unless the property involved is an old or historic building that has been substantially rehabilitated. This extension of the investment tax credit to old or historic buildings in 1981 made operating leases more attractive, although state and local governments have used operating leases for many years for a wide variety of property and equipment.

Tax-Exempt Lease-Purchase Arrangements

Growth and innovation in municipal leasing have largely been confined to tax-exempt lease-purchase arrangements and sale-leaseback agreements. In contrast to operating leases, lease-purchase agreements are essentially installment sales contracts providing for the acquisition of property by a governmental entity. Under the contract, the governmental unit makes periodic payments representing installments of the purchase price of the property plus interest. At the end of the contract term, the governmental unit will own the property or will acquire it for a nominal sum.

Tax-exempt lease-purchase agreements have to satisfy state and federal legal requirements that on the surface appear to conflict. From the standpoint of state law, the lease-purchase contract cannot constitute debt. For purposes of federal tax law, however, the contract must be an "obligation" of a governmental unit within the

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2. Economic Recovery Tax Act of 1981, Section 201.

meaning of Section 103 of the Tax Code. Accordingly, if the contract is an obligation of a governmental unit and is structured as an installment sale, rather than as a true lease, the interest portions of the payments will be exempt from federal taxation.

Since most states prohibit the obligations of a governmental unit under the lease-purchase contract from being subject to debt limitations, most tax-exempt leases have a so-called "non-appropriation" clause, which provides that the obligation of the governmental unit to continue making payments under the contract is subject to annual appropriation. This clause avoids having the agreements classified as long-term debt under state law and allows the governmental unit to terminate a lease without penalty, except for loss of the property, if the necessary funds are not appropriated. Vendors, or lessors, protect themselves from non-appropriation by charging a higher interest rate than for debt backed by the general obligation of the issuing authority and by including in the contract a clause prohibiting the governmental unit from leasing or purchasing replacement equipment for a specified time.

Uses. Tax-exempt leases have been used to acquire many kinds of equipment, from fire trucks to computers, and to a lesser but growing extent, to finance buildings and other real property. Typical transactions last from two to seven years, based on the useful life of the property, and tend to be for less than $1 million. The average lease is in the $100,000 to $200,000 range. Some recent transactions, however, have been much larger and for much longer-lived assets. These include:

- A $3.5 million police station in Los Angeles, which the city will purchase for a nominal sum at the end of the ten-year lease;

- A $34 million lease financing to fund a telephone system for San Diego County, California;

- A $54 million lease financing for new parking facilities in Anaheim, California;

- A $30 million jail and a $28.6 million school building program in Jefferson County, Colordao;

- A $23 million pier on the Columbia River for the Port of Portland, Oregon.

Financing. The financing of lease-purchase contracts depends on the size of the transaction. For smaller transactions, financing is usually provided by a single bank, insurance company, or wealthy investor. Smaller leases typically are privately placed, with a lease financing company or securities firm acting as intermediary. Larger transactions generally involve a number of investors who acquire rights to receive installment payments through certificates of participation in the lease-purchase contract. In these instances, a securities firm will underwrite a public offering or a limited placement to institutional investors. Certificates of participa-

tion, which are generally issued in units of $5,000, make it possible to market a lease financing to a large pool of investors in a manner similar to municipal bond offerings. If the offering is public, the certificates will be rated and it will be possible to trade them in secondary markets. (Ratings are usually one grade below the general obligation debt of the issuing locality, reflecting the perceived higher risk of the securities.) Privately placed, unrated leases are generally held by the lender.

Benefits and Drawbacks. For investors, leases are a source of tax-exempt income offering a higher rate of return than comparable tax-exempt obligations because of their perceived higher risk. (While purchasers of leases, or participations in them, are prohibited under federal law from taking depreciation deductions or tax credits on equipment or most kinds of property sold to local governments, they can treat the lease income as tax-exempt bond income.)

For municipalities, lease-purchase financing offers several advantages over bond financing. In addition to avoiding full cash outlay for property, it permits governmental units to finance the acquisition of capital goods without any concern about debt limits or any need to appeal to voters for approval to issue bonds. Because leases do not have the backing of the issuing authority, however, interest rates on them are higher than for general obligation bonds of similar size and term. For small transactions, the overall costs of leasing might well be lower than those of bond financing because arranging a privately-placed lease financing is less expensive than issuing bonds to the public. Moreover, lease-purchase agreements have the advantage of gearing the term of the contract to the life of the asset. In many cases, bonds are issued with maturities that far exceed the useful life of the equipment being financed. For large transactions involving certificates of participation, issuing costs are no lower than for bonds. In these instances, leasing is a means of financing capital acquisition without encumbering debt limits. It may also be a means of circumventing state interest-rate ceilings on bonded debt and of avoiding bond issuance procedures.

Volume. The volume of tax-exempt leasing is unknown. Most tax-exempt leases are privately placed, and no record of them exists beyond the local level. In the absence of federal reporting requirements, determining the volume of privately-placed tax-exempt leases would be exceedingly difficult. A few years ago, a similar problem arose with privately-placed small issue industrial revenue bonds. It turned out that enough state agencies imposed reporting requirements on local bond issuance activities to make it possible to arrive at reasonable estimates of the level of activity. So far, checks with selected state agencies have revealed that leasing is generally not subject to reporting requirements. According to Gregory Eden, Chairman of the Association for Municipal Leasing and Finance, tax-exempt leasing in 1982 amounted to about $2 billion, up from $1 billion in 1981. These estimates, which are based on known public offerings and other transactions reported by association members, are acknowledged to be rough. The volume does, however, appear to be increasing significantly.

Effects on Federal Revenues. In the absence of better estimates of the volume of net new tax-exempt leases, the costs are impossible to determine. Tax-exempt leases are not now included in the tax expenditure budget.

From the standpoint of federal revenues, tax-exempt leases are no different from tax-exempt bonds. Assuming that a project would be funded one way or another, the tax expenditure would be the same regardless of the financing mechanism. To the extent that leasing makes it possible to finance projects that otherwise would not go forward, however, tax expenditures conceivably may be higher, but by amounts impossible to determine with any confidence. In some instances, general obligation financing may be unavailable and leasing may be the only alternative. In other cases, municipalities may have alternative tax-exempt financing mechanisms.

Sale-Leasebacks

Although tax-exempt lease-purchase agreements are more prevalent, sale-leasebacks raise many more tax policy issues. Under sale-leaseback arrangements, a local government or tax-exempt institution sells public property to a private entity and simultaneously leases it back. The private entity makes an equity investment in the property and in return gets the benefits of ownership, which minimally include depreciation deductions. The local government or tax-exempt institution--such as a university, foundation, or church--gets a cash payment and an opportunity to lease back the facility at a reduced rate reflecting the owner's tax benefits. In order to meet IRS requirements, the nonprofit lessee cannot negotiate a repurchase price for the property in advance or buy the property back for less than its fair market value. The private entity must have a 20 percent minimum "at risk" investment in the project, and the lease has to generate income independent of the tax benefits.

Most sale-leaseback arrangements involve the rehabilitation of existing property or the construction of new facilities. Typically, sale-leasebacks involve at least four primary participants: a municipality, county, state, or tax-exempt organization, which owns and will subsequently lease back the property; a private equity investor; an underwriter, or lender; and a public authority, which will issue tax-exempt industrial revenue bonds to finance acquisition and construction costs.

Under ERTA, sale-leaseback arrangements have become much more attractive, largely because depreciation recovery periods are now shorter for most classes of property than they had been under previous law. In addition, ERTA also provides generous investment tax credits for the rehabilitation of buildings over 30 years old or of historic significance. With the exception of these older buildings, the investment tax credit is generally not available for assets used by governmental entities. If, however, the private entity enters into an operating lease with the owner for the provision of services, the investment may qualify for the credit. To date,

these types of arrangements at the municipal or county level have been confined to sewer and solid waste disposal systems.

Uses. So far, sale-leasebacks have been used or are being considered for convention centers, educational facilities, sewer and solid waste disposal systems, wastewater treatment plants, and all manner of public buildings from libraries to museums to city halls.

Sale-leaseback transactions are generally quite complex, and although not many have actually been completed, the numbers are growing. Probably the most widely publicized deal has been the sale of the City of Oakland's Museum and Auditorium. The museum was immediately leased back to the city, and the auditorium was rehabilitated for use as a convention center extension and subsequently leased back. Total financing amounted to $22 million for the museum and $20 million for the auditorium plus the costs of renovation. The expansion of a library in Sunnyvale, California, was financed under a similar arrangement. The City of Atlanta is reportedly considering a sale-leaseback to finance the rehabilitation of its city hall. The City of Norfolk, Virginia, recently did so; debt financing came from a $3 million industrial revenue bond. Many municipalities are looking into sale-leasebacks, particularly for historic structures. So are tax-exempt non-profit institutions, particularly universities. Transactions that are now under way or have been recently completed include:[3]

- The $6.3 million Pantages Center for the Performing Arts in Tacoma, Washington, that was rehabilitated with a combination of funds from the federal government, the state, and private contributors. Federal funding included a $1.5 million grant from the Economic Development Administration. Since EDA's regulations prohibited sale or lease of the property without the permission of the Secretary of Commerce, special legislation was required to make the leaseback possible. In December 1982, the Congress passed a rider to EDA's continuing resolution permitting the lease. Over a six-year period, the performing arts center will bring the city $1.72 million in cash from the equity investors. The city will invest the funds and, beginning in the seventh year, use the earnings to defray the operating costs of the theater, which are now running at $90,000 annually, and to pay net annual lease fees of $83,000 to the purchaser. A portion of the equity investment will also be used to set up a fund for the repurchase of the

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3. Sources of information on these transactions include The Weekly Bond Buyer (August 16, 1982, and April 18, 1983); The Washington Post (April 20, 1983); Urban Conservation Report (April 15, 1982, October 18, 1982, March 31, 1983, and April 15, 1983); Resources in Review (November 1982); and telephone interviews with attorneys, syndicators, financial consultants, investment bankers, and local officiofficials.

building when the lease expires at the end of 35 years. The building, which dated back to 1913, was located in an urban renewal area and listed on the National Register of Historic Places. Consequently, the equity investors will benefit from a 25 percent investment tax credit. The city is now giving preliminary consideration to the leaseback of a $44 million sports and convention center.

- In Seattle, Washington, the Pike Place Preservation and Redevelopment Authority has arranged three leasebacks. Two were completed before the passage of ERTA. The third was a $4 million rehabilitation of an historic building, Stewart House, that was developed into a mixed-use project with retail space on the ground level and both low-income housing for the elderly and single-room occupancy units on the upper stories.

- Bennington College is arranging to lease its 650-acre campus from private investors. According to the Washington Post (April 20, 1983), the college will receive the cash necessary to pay off a $2.5 million bank loan and will be able to pay the investors back over a 20-year period.

- Towson State University in Towson, Maryland, arranged a sale-leaseback to finance the construction of new dormitories. A test case involving the sale-leaseback of a training facility for restaurant workers in Baltimore had previously established that such transactions do not violate the state prohibition against borrowing without voter approval.

- The University of Nevada is considering a sale-leaseback for two new basketball pavilions. According to the Weekly Bond Buyer (April 18, 1983), "the two pavilions could be sold for about $60 million and the university would lease them back for 55 years through a $17 million tax-exempt bond issue. The arrangement . . . would provide the university with $1.5 million in operating funds for five to seven years."

- The City of Alexandria, Virginia, is selling its Torpedo Factory arts center for $4.5 million to a limited partnership. Financing for the project will come from a $2.5 million industrial revenue bond; an equity payment of about $1.0 million from the limited partners; and a second mortgage of about $1.0 million held by the city. The city will lease back the space for sublease to local artists.

- The Southwest Sewer District of Suffolk County, New York, plans to sell its sewer system to private investors for $811 million; of that amount, about $650 million will come from the sale of industrial revenue bonds. In this case, the county will enter into an operating lease with the owners for provision of sewer services. The limited partners presumably will be able to claim both depreciation deductions and an investment credit for the property. A number of legal issues remain to be resolved before the project

can go forward. At present, the transaction is expected to be completed some time in the fall of 1983.

Benefits and Drawbacks. For private equity investors, the benefits of sale-leaseback arrangements lie primarily in the tax shelters made possible by depreciation deductions and by investment tax credits, where available. In addition, lease payments made by the municipality provide a continuous rental income stream. (The rental income is fully taxable and, as such, differs substantially from payments made under lease-purchase agreements.) If industrial revenue bonds are used to finance acquisition and rehabilitation costs, investors in them will benefit from tax-exempt income. (Under current law, the equity investors cannot hold the IRBs; if they did, the bonds would be taxable.)

For municipalities, sale-leaseback arrangements provide a means of raising funds for capital improvements that may be less costly than issuing general obligation bonds. The lower costs result from the combination of the returns on the cash payments made by the private investors and the portion of tax benefits that private investors will pass on to the municipality in the form of lower rental fees.

Sale-leasebacks usually involve lengthy negotiations. Not the least of the problems that have to be considered are arrangements for the local government to repurchase the property when the lease expires. Generally, a lease will run for between 15 and 35 years, and thereafter the local government will have options to renew it if it cannot arrive at an acceptable purchase price. The repurchase price cannot be negotiated in advance; however, since the local government will usually retain ownership of the land, it will have some flexibility at the end of the initial lease period.

Effects on Federal Revenues. The effects of sale-leasebacks on federal revenues have so far been minimal. Potentially, however, they may be a vehicle both for off-budget revenue sharing with local governments and for providing subsidies to nontaxable institutions.

Essentially, one of the effects of current tax law has been to provide incentives for nontaxable entities to give up ownership of property and productive facilities and for private entities to make investments based primarily on tax considerations. The tax losses, if any, depend on the nature of the transaction. Assuming that a municipal sale-leaseback takes the place of tax-exempt financing that would otherwise occur and that the private investors borrow funds at conventional rates, any net losses to the federal government would be limited. The savings from not issuing tax-exempt municipal bonds would largely offset the revenues forgone from the equity investors' depreciation deductions. More typically, however, sale-leasebacks involve the issuance of tax-exempt industrial revenue bonds to finance property acquisition and rehabilitation. In these instances, the tax losses are substantially greater than those resulting from general obligation financing because they include the revenues forgone from issuing IRBs, coupled with the value of depreciation deductions and, in

some cases, investment tax credits. As an example, suppose a city government wished to rehabilitate its 50-year old city hall at a cost of $4 million. The city could either issue general obligation bonds or enter into a sale-leaseback agreement with a private partnership. If the private developer's acquisition and renovation costs were financed with tax-exempt IRBs, a sale-leaseback could cost the city less, and the federal government more, than rehabilitating the building with the proceeds of a general obligation bond issue. Under the sale-leaseback, the city would have to pay rent to the lessor and, 20 to 30 years later, repurchase the building at its fair market value. In the meantime, the city would benefit from the cash payment it received from the partnership, which it could invest in high-yielding securities, and from reduced rent payments, which would flow from the lessor's depreciation deductions, interest expense savings, and rehabilitation tax credits. Over a 20-year lease term, the present value of the net costs to the federal government of these benefits would be $2.6 million. By comparison, if the city floated general obligation bonds, the federal government would incur costs of about $1.1 million. Although the difference would not show up as a line item in the federal budget, the city government would nevertheless benefit from additional subsidies that effectively reduced its financing costs below the level of general obligation funding, and the private investors would benefit from generous tax writeoffs.[4]

When such nontaxable entities as universities engage in sale-leasebacks, the result may be an even greater net drain on federal revenues. These institutions often use tax-exempt debt for physical plant. But if a university sells and leases back its campus and uses the cash payment to set up an endowment or a scholarship fund, it benefits from depreciation deductions, while the federal government receives no offsetting saving from forgone tax-exempt bond financing.

Safe-Harbor Leases

Safe-harbor leasing was designed primarily for private-sector transactions. With the passage of ERTA, governmental entities have been able to take advantage

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4. These calculations assume 20-year tax-exempt financing at 9.4 percent, an alternative taxable rate of 12.0 percent, and a discount rate of 10 percent. They also assume, for the renovated structure worth $5 million, a 20 percent rehabilitation tax credit, a full basis adjustment, 15-year straight-line depreciation for the improved building, and 5-year straight-line depreciation for equipment. Of the $4.2 million in depreciable property, $3.9 million is for the building and $0.3 million is for equipment. The costs to the federal government represent after-tax dollars and are offset by the net revenues generated from the rental income of the lessors, estimated at $400,000 a year for 20 years. The net rental income consists of lease payments minus interest deductions. (The city pays maintenance and operations costs.) The investors are assumed to be in the 50 percent marginal tax bracket.

of safe-harbor leasing for mass transit rolling stock vehicles financed completely or partially with tax-exempt bonds. Generally, a transit authority or local government purchases the rolling stock and sells it to a private firm. The firm, which benefits from depreciation deductions, then leases the equipment to the local government at a rate that reflects its tax savings. Several public transit authorities have negotiated such leases. In this instance, the Congress chose to extend tax benefits to transactions involving local governments and transit authorities in order to reduce the cost of public mass transit equipment. The Tax Equity and Fiscal Responsibility Act of 1982, which repealed safe-harbor leasing generally as of January 1, 1984, extended its use for mass transit vehicles until January 1, 1988.[5]

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5. Tax Equity and Fiscal Responsibility Act of 1982, Section 208.